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International Economic & Energy Weekly

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22 February 1985

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DI IEEW 85-008
22 February 1985

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Comments and queries regarding this publication are welcome. They may be directed to Directorate of Intelligence,

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Sanitized Copy Approved for Release 2011/03/02 : CIA-RDP97-00771R000707410001-3

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Perspective

Japan: Limited Trade Impact of Import Liberalization

Prospects for new initiatives by Japan aimed at opening domestic markets have improved in recent weeks, but a narrowing of the US trade deficit with Japan—which hit a record $33 billion in 1984—is unlikely this year. We believe the strength of the dollar, Tokyo's insistence on incremental liberalization, and the nature of some of the four sectors the United States has targeted for action—telecommunications, electronics, forest products, and medical equipment and pharmaceuticals—will limit the trade impact of concessions made during coming months. 25X1

Despite Prime Minister Nakasone's pledge to President Reagan on 2 January that Japan would pursue a market-oriented sector-specific (MOSS) approach to boost manufactures imports, trade concessions looked like a long shot after Nakasone returned to Tokyo. Influential members of the ruling Liberal Democratic Party (LDP) publicly criticized the Prime Minister for promising action on the trade front without advance clearance from the party. Tempers in the LDP subsequently cooled, and the ministries responsible for the four sectors abandoned earlier attempts to work out an alternative to the MOSS approach. Political and economic considerations still constrain Japanese willingness to give ground in all areas, but removal of some import impediments appears likely. 25X1

The decision to tackle problems first in the telecommunications sector—made at a late January bilateral meeting—is propitious, in our view. Developments in that sector parallel those in the financial sector, the focus of the successful yen/dollar talks; these in turn provided the model for the MOSS approach. In both cases, the process of deregulation already had begun—largely on the insistence of important elements of the bureaucracy and domestic industry—before the United States applied pressure for reform. Under such circumstances, foreign pressure for liberalization stands a good chance of adding to existing momentum and affecting choices about particular liberalization measures. We see similar domestic pressures emerging, although on a much more limited scale, in the electronics and medical sectors as well. In contrast, the Japanese seem united in their desire to protect the ailing forestry industry, and thus prospects for import liberalization in this sector are bleak.

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In other respects, the parallels between the telecommunications and financial cases are worrisome. In both areas, powerful advocates of the status quo are causing policymakers to opt for incremental liberalization. Foreigners may be able to make significant inroads into these markets over time, but the immediate trade impact from each step of the deregulation process probably will be small. As with the financial sector, the growth area in telecommunications involves sales of services rather than those of manufactured goods. [redacted] 25X1

Exchange rate trends, unless reversed, reinforce the likelihood of a small payoff from Tokyo's concessions. Although a healthy increase in Japanese domestic demand is expected in 1985, the dollar's strength probably will limit the ability of US exporters to translate such increases into sales of manufactured goods in any sector. If the yen's weakness against the dollar is reversed, however, the experiences of 1971-73 and 1977-79 suggest that Japanese imports could snowball. In each case, yen appreciation of 25 to 30 percent led to a doubling of manufactured imports within two years. [redacted] 25X1

Japanese officials admit correction of the yen/dollar exchange rate misalignment is central to easing trade tensions but are reluctant to take measures to boost the yen's value. Finance officials have categorized available options as either ineffective—fiscal stimulus or exchange market intervention if done unilaterally—or unpalatable—controls on capital outflow or tighter monetary policy. Moreover, they do not believe the yen's current weakness is adversely affecting the health of the economy. Finally, they insist US fiscal policies rather than Japanese policies are responsible for the yen/dollar misalignment. Unless Tokyo's assessments change, we believe the Japanese Government will continue to let market forces dictate the yen exchange rate. [redacted] 25X1

[redacted] 25X1

Briefs

Energy

East Germany Buys West German Coal

East Germany has bought at least 140,000 metric tons of West German coal—its first significant purchase since 1981—to combat its worst cold weather energy shortages since 1978-79. The freezing of lignite in the ground has caused power shortages that the regime itself implicitly blamed for a decline in the growth of industrial production in January. The East Germans apparently bought the coal through normal trade channels, and the purchase probably does not signal a significant change in the intra-German economic relationship. 25X1

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International Finance

Brazilian Financial Pressures Reemerging

Brazil's recent financial setbacks will place mounting economic and political pressures on President-elect Neves, who takes office on 15 March. The IMF recently announced suspension of a $400 million disbursement for Brazil, largely because of dissatisfaction with its rapid monetary expansion and resurging inflation. Bank creditors are holding up a multiyear debt rescheduling package pending IMF support for a new Brazilian stabilization plan. Meanwhile, banks in one southern state are collapsing, according to the US Embassy. The Central Bank is providing capital to save several major banks, but rumors are now circulating that some Sao Paulo financial institutions may be insolvent. 25X1

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Brasilia is unlikely to resolve its differences with the IMF before spring, partly because programs to bail out banks will further expand the monetary supply and aggravate inflation. Although the Neves administration initially will be able to manage its external finances by drawing down its replenished international reserves, it may encounter serious difficulties in getting its financial rescue program back on track. Many of Neves's supporters will urge him to resist harsher IMF conditions and to seek more favorable terms from the international banks. Neves probably now has the political strength to maintain a moderate position on the debt issue and to resist calls to restart negotiations. The protracted debt negotiations will distract him from the task of consolidating his political position, however, which could compel him to toughen his stance with creditors later.

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[redacted] 25X1

National Developments

Developed Countries

Possible Airbus Sale to Spain

US Embassy reports indicate that Airbus Industrie is attempting to capture a large share of replacement sales to Spain's national airline, Iberia. Airbus hopes to replace a mix of 65 DC-9s and B727s with its all new 150-passenger A320 aircraft. To fill Iberia's immediate need for replacement of aging DC-9s, Airbus is suggesting that it purchase Fokker's new F-100s. This would deny early replacement sales to US companies and ease A320 sales when the aircraft are available. Airbus's aggressive sales effort includes discounts approaching 20 percent for purchasers of the first A320s. Moreover, sales proposals to British Airways and Monarch, the UK charter carrier, include offers to accept new B757s in trade. [redacted] 25X1 25X1

Less Developed Countries

Saudi Arabia Tightening Regulations on Worker Permits

Companies that want to bring foreign workers into Saudi Arabia now face one more step in the already cumbersome process of obtaining worker permits. The Saudi Ministry of Labor is beginning to enforce a regulation, on the books since 1969, that requires a denial of work permit requests if there is a qualified Saudi "available to fill the position." Companies not making an honest effort to employ Saudis will be denied the right to import labor; according to an Embassy source in the Ministry of Labor, more than 100 companies have been put on this list. During the past 10 years when any Saudi who wanted a job could easily get one, the regulation had been ignored, but now many Saudis, particularly recent graduates of Saudi Arabia's universities and training institutes, are having difficulty finding acceptable jobs. [redacted] 25X1 25X1

[redacted] 25X1

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Morocco Trims Education Sector

King Hassan has called on teachers to work 20 percent longer hours, forgo salary increases, and limit any strike actions to wearing armbands. This is the latest move in Morocco's sporadic effort to reduce education expenses—30 percent of the administrative budget—without touching off unrest such as occurred in January 1984, according to the US Embassy. The budget cut probably also is directed at World Bank, IMF, and foreign creditors to gain concessions in upcoming rescheduling negotiations. US Embassy and local press reports indicate early signs of restiveness among teachers and students over the King's speech. Teachers unions blame these proposed measures on the influence of international financial institutions in domestic affairs. Free education is considered a right by Moroccans and employs over one-half of the civilian government work force. With food price increases around the corner, King Hassan probably is warning all sectors that additional belt-tightening is likely. 25X1

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Salvadoran Remittances Cushion Living Standards

The US Embassy estimates that Salvadorans working in the United States remit earnings of roughly $360 million per year—substantially higher than the Central Bank's estimate of $60 million. Although precise figures are difficult to obtain since most of the money is exchanged on the black market, the Embassy believes remittances are now second only to coffee exports—$460 million in 1984—as a source of foreign exchange. Remittances are likely to grow as the number of Salvadorans working abroad rises. This inflow of funds has cushioned the drop in private consumption levels despite the 35-percent decline in real per capita GDP since 1979. The higher living standards supported by remittances probably have already contributed to the apparent decrease in support for radical solutions to the country's many problems, including the unequal distribution of income and wealth. 25X1

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Political Attacks on Mexican Business

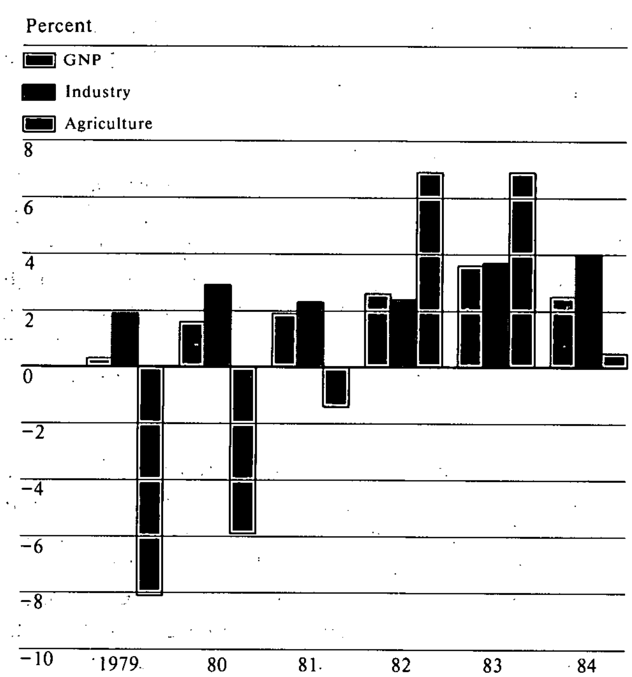
The government is sharply escalating criticism of local businessmen who support the center-right National Action Party, which is mounting an unprecedented challenge to the ruling party in upcoming midterm elections. In recent weeks, President de la Madrid, ruling party officials, and leaders of organized labor have characterized business supporters of the opposition as "traitors" and "reactionaries" seeking personal gain from the economic crisis. This is the strongest such criticism of business since the end of former President Lopez Portillo's term. Business organizations, particularly in the north, have rejected the charges as "scapegoatism" and warned of violence if the government does not respect the results of the 7 July vote. The government 25X1 is attempting to discredit the National Action Party by portraying it as a tool of big business. Such antibusiness rhetoric will further erode business confidence in the government and heighten political tensions that recently led to localized violence along the US border. 25X1

Communist

Soviet Economic Growth in 1984

Mixed economic performance last year held Soviet GNP growth to about 2.5 percent—below the 3.7 percent growth rate in 1983 but still better than the unusually slow pace of 1979-81. Industrial growth, led by machinery production, rose slightly to almost 4 percent. Among energy sectors, growth of electric power and gas was rapid, but production of coal and oil declined somewhat. Growth in transportation slowed compared with 1983 as highway shipments fell and rail traffic posted below-plan growth. Agricultural output grew only slightly, in part because of bad weather. Record output of meat, milk, and eggs, along with surprisingly good potato and vegetable crops, offset disappointing results for other major crops. 25X1 25X1

USSR: Economic Growth Rates, 1979-84



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Per capita consumption probably grew slightly faster than in 1983, at about 2 percent, reflecting improved growth in retail trade and food supplies. On the other hand, growth in investment appeared to slow sharply, to roughly 2 percent, well below average annual increases of about 4 percent during the period 1981-83. If the trend continues, the reduced rate would require sharp increases in productivity to avoid jeopardizing economic expansion. [redacted] 25X1

Increased industrial output last year came from gains in productivity, not faster growth of labor and capital inputs. Soviet planners have also had some success improving supplies of basic materials and reducing rail tieups. At the same time, discipline and anticorruption initiatives seem to have prompted both management and labor to greater effort. Although Soviet statistics contain no direct evidence on defense spending, recent improvements in industry do give the regime more leeway to increase growth in defense without reducing growth in consumption and investment. [redacted] 25X1

Western Europe Cuts Aid to Vietnam

[redacted]

The EC's decision this month—in the midst of Hanoi's aggressive dry-season offensive in Cambodia—to stop humanitarian assistance to Vietnam is another indication of Western Europe's increasing dissatisfaction with Vietnam's economic and political policies. The halt of EC aid, which has averaged $300,000 annually in the past few years, follows the refusal last fall of Hanoi's request for emergency food assistance. Sweden, moreover, is gradually disengaging from its $80 million aid program in Vietnam and recently complained to Hanoi about the use of forced labor and deplorable living conditions for workers at its major aid project, the Bai Bang papermill. Stockholm has also been unhappy with the corruption, inefficiency, and mismanagement there. Although Vietnam can ill afford any reductions in external assistance—one of its few remaining sources of hard currency—Hanoi is unlikely to make policy concessions to win it back. [redacted] 25X1 25X1

New Vietnamese Interest Rate Policy

[redacted]

According to Vietnamese press reports, Hanoi last month roughly doubled deposit rates at government banks and credit cooperatives to a range of 24 to 36 percent annually. The new policy is an attempt to expand the share of investment financed by the banking system after the failure of the 18-month-old campaign to sell government bonds. The impact of these higher rates on national savings will depend largely on the government's ability to slow inflation, now running at 50 to 60 percent annually. Hanoi, however, has given no indication that it plans curbs on credit creation or budget deficits in the near future. [redacted] 25X1 25X1

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Egypt: Economic Outlook on the Eve of Mubarak's Visit [redacted] 25X1

Egypt will need to undertake some major economic reforms to deal with the prospect of widening current account deficits over the next several years. Even without a further decline in oil prices, we expect oil revenues will soon begin to fall as a result of rapidly growing domestic consumption. Remittances from workers abroad, Cairo's second-largest source of foreign exchange, together with Suez Canal earnings also are likely to level off. These adverse developments, when added to stagnant agricultural output and a rapidly growing urban population, will force Cairo to develop alternative revenue sources if it is to avoid the introduction of austerity measures at a destabilizing pace. [redacted] 25X1

The modest price and exchange rate measures recently implemented or proposed do not, we believe, constitute a fundamental restructuring, nor will they alone alter significantly the economic outlook. Nonetheless, Cairo will cite these reforms as proof of its commitment to rebuild the sagging Egyptian economy and as justification for increased US aid. If President Mubarak's government stands firm on these initial actions in the face of political unrest, it could build confidence and lay the groundwork for a sustained and even accelerated program of urgently needed reforms. We believe, however, the government remains unconvinced that the populace would accept comprehensive reforms. [redacted]

Egypt: Current Account Balance [a] *Billion US $*

	1982	1983	1984 [b]	1985 [c]
Current account balance	**−2.4**	**−2.2**	**−2.5**	**−2.7**
Trade balance	−5.0	−5.5	−5.8	−5.9
Exports, f.o.b.	3.6	3.5	3.6	3.9
Oil	2.3	2.2	2.3	2.6
Imports, c.i.f.	8.6	9.0	9.4	9.8
Net services	2.6	3.2	3.2	3.2
Receipts	5.4	6.3	6.5	6.8
Remittances	2.1	2.8	3.0	3.3
Suez Canal	0.9	1.0	1.0	1.0
Tourism	0.6	0.7	0.7	0.7
Other	1.8	1.8	1.8	1.8
Payments	2.9	3.1	3.3	3.5
Unrequited transfers	NEGL	0.1	0.1	0.1

[redacted] 25X1

[b] Preliminary.
[c] Estimated.

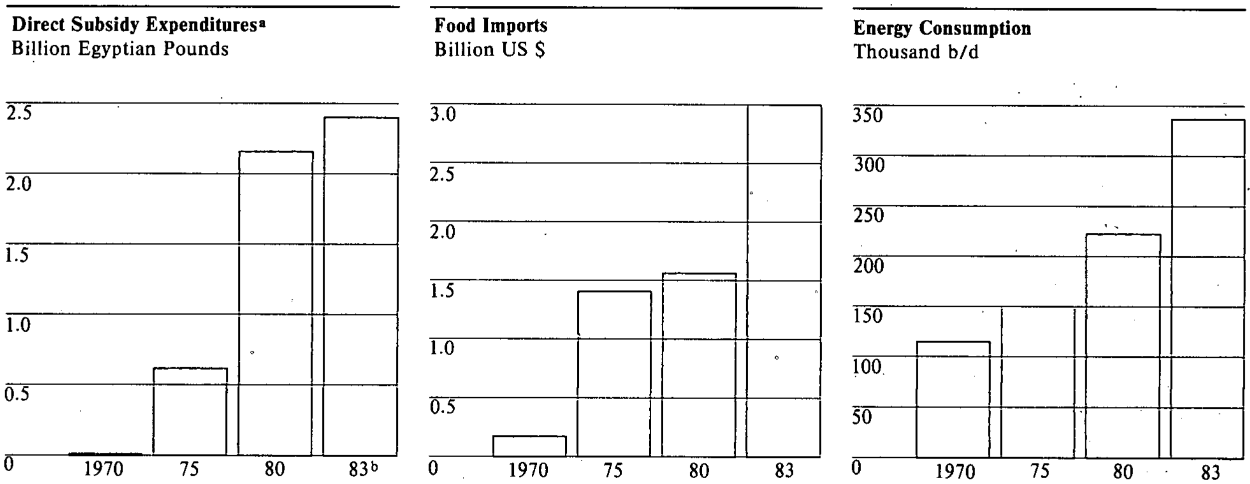
[redacted] 25X1

Reform of the Foreign Exchange System

In its latest attempt to reform its complex, multi-tiered system of exchange rates, Egypt recently introduced a new variable rate, designed to bring more of the estimated $3-6 billion in annual remittances from Egyptians abroad back into commercial bank channels. The IMF estimated that, in 1982, 25 percent of the total remittances went through free market channels and that share has continued to increase, as the Egyptian pound has become increasingly overvalued. [redacted] 25X1

If the spread below the free market rate (currently about 8 percent) is allowed to grow—as it has after previous currency reforms—the share of remittances entering through commercial bank channels is unlikely to increase. Thus far, Cairo has allowed

Egypt: The Impact of Subsidies, 1970-83



[a] Fiscal years.
[b] Budgeted.

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small adjustments in its new flexible rate, but it has not yet been faced with a major increase in the free market rate.

Egypt also has introduced a fairly restrictive import allocation system, designed in part to ensure that import levels are consistent with the availability of foreign exchange. We doubt that this government-administered system will inspire much confidence within the private sector. There reportedly already is concern within the local banking community about whether there will be sufficient foreign exchange to cover private import transactions and permit growth in the private sector.

Prices and Subsidies

The impact of this partial devaluation on consumer prices will hinge on how rapidly the government reforms Egypt's pervasive subsidy system. The subsidies, along with rapid population growth and higher-than-average economic growth, have greatly inflated demand. Food imports alone consume about 30 percent of Egypt's total foreign exchange earnings—compared with an average of 13 percent for all LDCs. Implicit subsidies also keep energy prices at an average of less than 20 percent of world market levels. 25X1 25X1

The government, because of deeply held notions of equity and fears of a violent public response, has thus far shown painstaking caution in reducing subsidies. Generous financial support from international banks and aid donors, with few strings attached, has made reform seem less urgent to Egypt. 25X1 25X1

Since Kamal Hassan Ali became Prime Minister in July 1984, however, Cairo appears to realize, according to the US Embassy, that it may rapidly be running out of time to deal with its economic problems. Recent efforts at reform include:
- A doubling in the price of flour and introduction of a 2-piaster bread loaf to replace the older 1-piaster loaf in some neighborhoods.

- A 20- to 30-percent increase in the price of locally produced cigarettes—reportedly enough to eliminate the operating deficit in the public sector's manufacture of cigarettes.
- Introduction of tolls on the Cairo-Alexandria road, establishing the fee-for-service principle on one of Egypt's primary limited access highways. [redacted]

In addition, producer prices for seed cotton, wheat, and sugarcane have been raised. Most of the reforms were accepted with little public opposition, with the exception of the 2-piaster loaf. In this case, public demonstrations led the government to restrict distribution of the more expensive loaf to well-to-do neighborhoods. The government reportedly still plans to go ahead with wider distribution of the 2-piaster loaf in the near future. [redacted]

Reform has been least extensive in the case of energy prices. A 10- to 20-percent increase in the cost of electricity last fall along with previous increases have helped narrow but not eliminate the large gap between prices and the cost of production. Price increases in petroleum products, promised last fall, failed to materialize—largely because the government was unwilling to pass the increases on to public-sector companies—in turn raising prices of various government-regulated products. [redacted]

The Mubarak government is contemplating other energy reforms:

- Introduction of a new premium grade of gasoline, to be priced 66 percent above the current highest grade.
- Substantial hikes in electricity prices, perhaps nearly to world market levels, for excess consumption by households (beyond the first 100 kilowatts per month) and by private commercial enterprises.

Even if these reforms were enacted, we doubt that such a piecemeal, incremental approach would yield the improved resource allocation and productivity that Egypt needs so urgently. Moreover, by shielding public-sector industries from price reforms, industry will remain uncompetitive in overseas markets. Egypt is also unlikely to attract enough private foreign investment to modernize its capital stock. Finally, progress in raising producer prices for agricultural products must be sustained or investment in agriculture will continue to stagnate, and Egypt's large net food deficit will grow. 25X1
[redacted]

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Impact of Falling Oil Prices

Egypt's oil export earnings are likely to fall over the next five years as a result of rapidly growing domestic energy consumption, even if real oil prices remain relatively constant. Crude oil production will rise over the next one to two years, approaching 1 million barrels per day in 1986. Most of this 25X1
increase, however, will be used to satisfy internal demands stimulated by heavily subsidized domestic energy prices. Even if the increase in energy consumption moderates and domestic gas utilization rises, the amount of oil available for export will still shrink considerably by 1990. We estimate that oil export revenues may fall below $1 billion by the end of the decade, a 60-percent drop from current 25X1
levels. [redacted]

A precipitous decline in world oil prices would have an even more serious and immediate impact on the Egyptian economy. 25X1
With no excess lifting capacity, Egypt's crude oil earnings would fall in proportion to the price decline, plus an additional amount for cost recovery expenses owed to foreign oil companies. The latest round of price adjustments entailed a 50-cent-per-barrel reduction in the price of Egyptian crude, or about $80 million in unrealized 1985 oil earnings. Each additional $1 per barrel decline in price would imply a roughly $160 million annual reduction in export revenue. [redacted] 25X1

Reductions in oil earnings will exacerbate the current shortage of funds in the Central Bank's foreign exchange pool. Moreover, reduced oil tax revenues would push already large budget deficits higher and spur inflationary bank financing of the deficit, or harsher austerity measures. [redacted]

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A rapid or prolonged oil price decline would also likely cause remittance earnings to level off or even fall over the next several years. To date, the US Embassy in Cairo has seen little evidence of a net inflow of Egyptians from abroad. Except in Libya, Egyptian workers appear to be staying in place partly because many are in skilled professions and unlikely to be affected by the first cutbacks in spending by the oil economies of the Persian Gulf region. An extensive repatriation of these workers, however, not only would reduce foreign exchange earnings but also likely add to unemployment and possibly political agitation among those returnees concentrated in urban areas.

Debt Servicing Problems Grow

The decline in oil and oil-related foreign exchange earnings will aggravate already serious debt servicing problems. According to Embassy reporting, Egypt's current external debt—excluding $2.5 billion owed to the USSR and not being serviced—probably exceeds $31 billion. This includes $25.8 billion in civilian debts and an estimated $5.6 billion in military obligations. Servicing this debt requires more than $3.5 billion annually and absorbs roughly 35 percent of current earnings.

A serious debt management problem could develop by midyear if Central Bank receipts continue to slide. A $200 million syndicated bank loan falls due 15 July. Failure to repay this credit, as well as other obligations coming due, could jeopardize Cairo's access to short-term financing.

The Egyptians have already singled out US Foreign Military Sales (FMS) debt relief as a major issue in its bilateral economic agenda with the United States. Cairo owes $3.7 billion in FMS credits, and servicing during the current year is projected at $470 million, or roughly 13 percent of Egypt's annual debt service requirement. Mubarak probably views FMS rescheduling as the most promising debt relief alternative, given his perception that the United States attaches high importance to the US-Egyptian security relationship.

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Bolivia: Daunting Economic Challenges

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President Siles's populist policies have plunged Bolivia into its most crippling economic crisis in 20 years. On 9 February he announced policy adjustments to break the economic plunge, but we judge Siles will again falter in implementing thoroughgoing reforms in the face of popular unrest. With presidential elections advanced a full year to June, Siles likely will pass on an economy riddled with severe distortions resulting from the world's highest inflation rate. For the new government, rebuilding the economy will be politically difficult, necessitating tough domestic adjustments, a reconciliation with creditors, and large-scale Western assistance to bolster the fledgling democracy

Growing Economic Chaos

Bolivia's economy is now reeling under hyperinflation consistently. Last year, inflation soared to 2,177 percent according to Bolivian Government figures and jumped to 3,400 percent (at an annual rate) in January, reports the US Embassy. Economic contraction throughout the industrial sector has driven unemployment and underemployment to about 30 percent of the labor force. Despite huge wage hikes, consumer purchasing power is eroding. Strikes for higher pay are disrupting essential services and normal production, and shortages of basic food items are growing increasingly severe, according to press reports.

To break the hyperinflationary spiral, Siles implemented economic adjustments on 9 February. La Paz devalued the peso by 80 percent; raised food, fuel, and transportation prices by an average of 400 percent; but granted workers a 330-percent wage hike to offset partially the impact of these adjustments on living standards. The US Embassy also indicates that the administration has promised to implement complementary measures to rein in the ballooning public deficit—by tax hikes and spending restraints—curb rapid monetary expansion, and ensure more frequent adjustments of controlled prices to market levels. As of 20 February, however, the Siles administration has yet to announce additional financial reforms. 25X1

Economic deterioration and political pressures have already caused Siles to announce that he will resign one year early. Even if Siles follows through with reform measures, the new government, to be inaugurated in August, will face major hurdles in restoring economic stability and rekindling growth. 25X1

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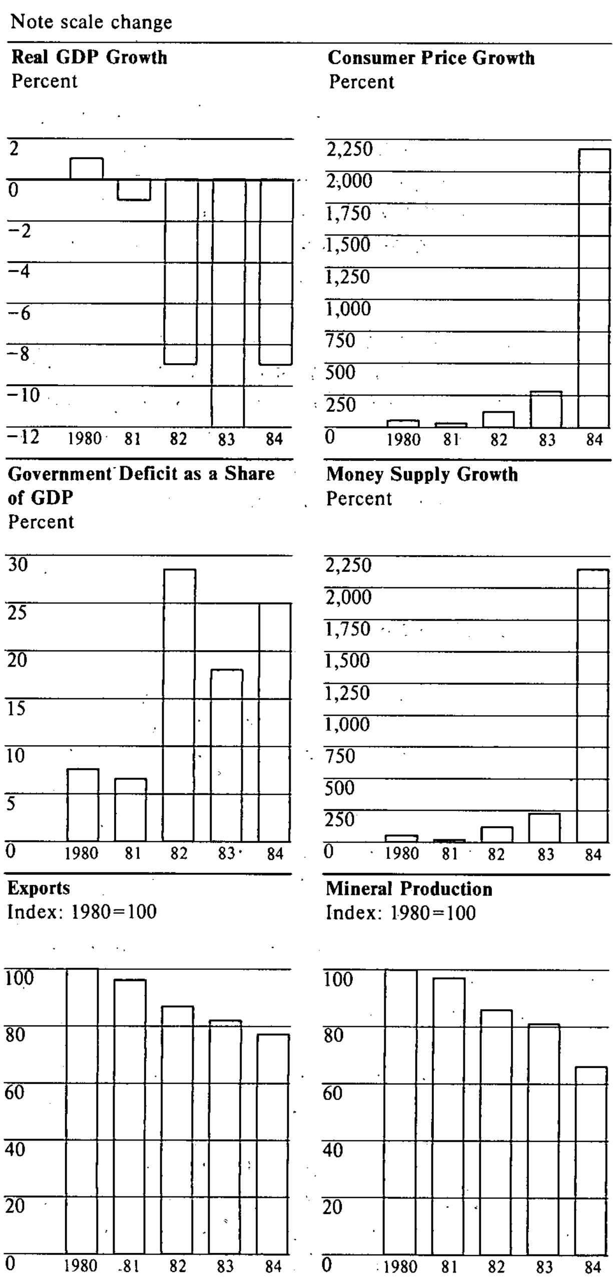
Controlling Inflation

Breaking the inflationary spiral will require restoring fiscal discipline through institutional reform. Without budget controls and an independent Central Bank, La Paz has simply printed more currency to finance huge government-decreed wage hikes and increases in public spending, the US Embassy reports. The government deficit has tripled since 1980 to 25 percent of GDP in 1984. Bolivia's planning minister said that unless inflation is curtailed, the fiscal deficit could rise to 60 percent of GDP in 1985. 25X1

Runaway inflation will leave the economy riddled with distortions. Unless future government price adjustments match prevailing inflation, manufacturers will still have incentive to channel their goods into the black market or shut down production. The US Embassy also reports that up to 50 percent of some commodities—flour, sugar, gasoline—are smuggled to neighboring countries, and 25X1

Bolivia: Economic Indicators, 1980-84[a]



[a] Data for 1984 are estimated.

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these illegal transactions are likely to continue until the official Bolivian exchange rate is adjusted to free market levels. 25X1

The peso remains overvalued despite three major devaluations last year and another this year. Exports declined 8 percent in 1984, in large part, because of La Paz's reluctance to float the currency. Although La Paz recently raised the official exchange rate from 9,000 to 45,000 pesos per US dollar, the rate is currently about 140,000 to the dollar in the parallel market. Producers, who are obligated to surrender most of their foreign exchange earnings at the low official rate, have little incentive to export, thereby intensifying the foreign exchange crisis. 25X1

Revitalizing Production

The next administration will also face the chore of restoring domestic production, now barely 60 percent of its 1978 level. Industrial output has plummeted because of the combined effects of depressed demand, wildcat strikes, plant shutdowns, and lack of foreign exchange to buy essential raw materials and import equipment. Bolivian industrialists recently told the US Embassy that foreign exchange was insufficient to enable industry to use even half its capacity in 1984. Moreover, minerals production, mainly tin, has fallen to its lowest level in 10 years because of the lack of exploration and failure to upgrade obsolete equipment. 25X1

Reviving production will also entail restoring Bolivia's credibility with foreign investors. La Paz's record of arbitrary commercial regulation and continued stalling on payments due on an $80 million debt to US oil companies have deterred new foreign investment. Preliminary statistics indicate foreign direct investment plummeted more than 80 percent in 1984 to only $7 million. Additionally, a recent series of decrees has undermined the banking sector's profitability, driving three US banks to close their Bolivian offices in the last two months. Faced with debt servicing payments larger than export revenues, Bolivia unilaterally ceased payment on its

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commercial bank debt last June, and now has overdue interest and principal payments of some $200 million. As a result, Western bankers refuse to reopen access to credits for new Bolivian development projects. [redacted]

Prospects for Near-Term Reform

Although Siles's recent economic moves are a step in the right direction, these measures remain incomplete, in our view, because they fail to control the fiscal deficit and monetary expansion. Because past packages have failed to follow through with structural adjustments, we judge President Siles will probably continue to avoid comprehensive economic reforms in the preelection period out of fear that increasing popular unrest would provide military coup plotters an opportunity to oust him. [redacted] a climate of anarchy stemming from economic disorder would rally disparate armed forces factions in favor of direct military intervention. Although Bolivia's powerful labor confederation has reacted to the measures with restraint thus far, another nationwide general strike remains a possibility. Meanwhile, wildcat strikes and popular demonstrations have erupted in opposition to the government austerity package. As in the past, we believe Siles likely will resort to populist measures, such as further wage hikes and consumer subsidies, to placate economic discontent. This approach will probably be politically successful in weathering the present wave of opposition, but failure to enact coherent and comprehensive stabilization policies will result in a deepening economic crisis for the next government. [redacted]

We and the US Embassy remain concerned that—although highly unlikely—Siles may attempt a social revolution. Siles has a romantic attachment to leftist populism and wants to be remembered as the defender and hero of the common man. Recognizing his resignation as an admission of failure, Siles could decide to go out in a blaze of revolutionary glory, undertaking highly expansionary policies and extending state control over the economy. In our view, this would cause the modern economy to collapse. Under these circumstances, to further bolster his popular support, we believe Siles probably would also repudiate Bolivia's debts to US banks and firms, as well as to government and international lenders. Siles likely would seek wider political backing for repudiation from other Latin Ameican debtors, but we judge there is almost no chance that the other debtors would support him. [redacted] 25X1

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Implications

For Siles's successor, halting Bolivia's economic slide and revitalizing growth will mean having to take a number of politically difficult reform measures that probably would produce strong popular reaction. Controlling inflation will entail slashing the national deficit with both large tax hikes and substantial cuts in government spending accompanied by monetary restraint. Ending contraband exports of consumer essentials will require lifting price controls and a massive devaluation to restore export competitiveness. [redacted] 25X1 25X1

Reconciliation with creditors also is necessary for La Paz to attract new assistance from multilateral donors, and eventually to reopen lines of commercial credit. [redacted] we believe bankers will refuse to provide financial assistance until Bolivia resumes interest payments and implements an IMF stabilization program. Consequently, we expect the next adminstration to seek new large-scale economic assistance from the United States and other Western nations to buffer popular reaction to austerity, buying time to reconstruct the economy and buttress democracy. 25X1 25X1

[redacted] 25X1

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Pakistan: Preelection Economics

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President Zia, we believe, has accomplished his primary economic goal—maintaining domestic prosperity during his presidency and denying the opposition a rallying point. His economic record is generally strong on the eve of Provincial and National Assembly elections later this month, and preliminary data indicate the economy is growing at a record pace. Part of Zia's success, however, has been a result of a sizable flow of remittances from Pakistani workers in the Middle East. With remittances now declining and spending on imports rising rapidly, Pakistan's current account is deteriorating. If the brakes are not put on the foreign exchange outflow or if substantial new aid is not forthcoming, serious foreign payments problems will emerge in the next 18 months.

Economic Performance Under Zia

The government is predicting record real growth of 9.9 percent in FY 1985 [1]—up sharply from the 3.5-percent growth in FY 1984, and well above the 6-percent annual average of FY 1978-83. The relatively poor FY 1984 performance primarily reflected bad weather, some mismanagement in the agricultural sector, and shortfalls in public- and private-sector financing. Government concern over lingering problems became apparent last November when Planning and Development Minister Mahbubul Haq announced that the five-year economic development plan for 1983-88 would be replaced by a "rolling" three-year plan.

A spectacular recovery this year in agriculture and last year's low real GDP growth makes the official estimate for this year plausible. Growth in the agricultural sector, which accounts for about one-fourth of GDP and employs over half the work force, is predicted to rise 12.6 percent in FY 1985 following a 6.2-percent drop in FY 1984:

- Government and industry officials estimate the cotton crop may reach 970,000 metric tons, double last year's disastrous harvest.
- Favorable weather has encouraged officials to predict record wheat and rice harvests. A recent government decision to increase the procurement price for wheat this April should prompt farmers to use higher cost inputs—particularly fertilizer and pesticides—resulting in increased yields.

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The government also is projecting an 11.5-percent growth in industrial production: 25X1

- The bumper cotton crop should buoy domestic cotton processing and textile manufacturing, the country's largest industry.
- The Planning and Development Minister claims new capacity in the jute, vegetable oil, beverage, and electronics industries will boost output.
- Several new oil discoveries are creating a mini-boom in the domestic petroleum industry. Oil output averaged almost 26,000 b/d in December, twice the average for 1983. 25X1

Preliminary evidence indicates consumer price increases may be in the double-digit category this year, but the government has done a relatively good job of shielding the population from higher prices for basic items. It has released commodities from government stocks and imported basic items in short supply. Islamabad has absorbed most of the increase in the cost of imported cooking oil. Heavy subsidies on wheat prices continue. No announcement has been made on how much, if any, of this 25X1

[1] The Pakistani fiscal year ends on 30 June.

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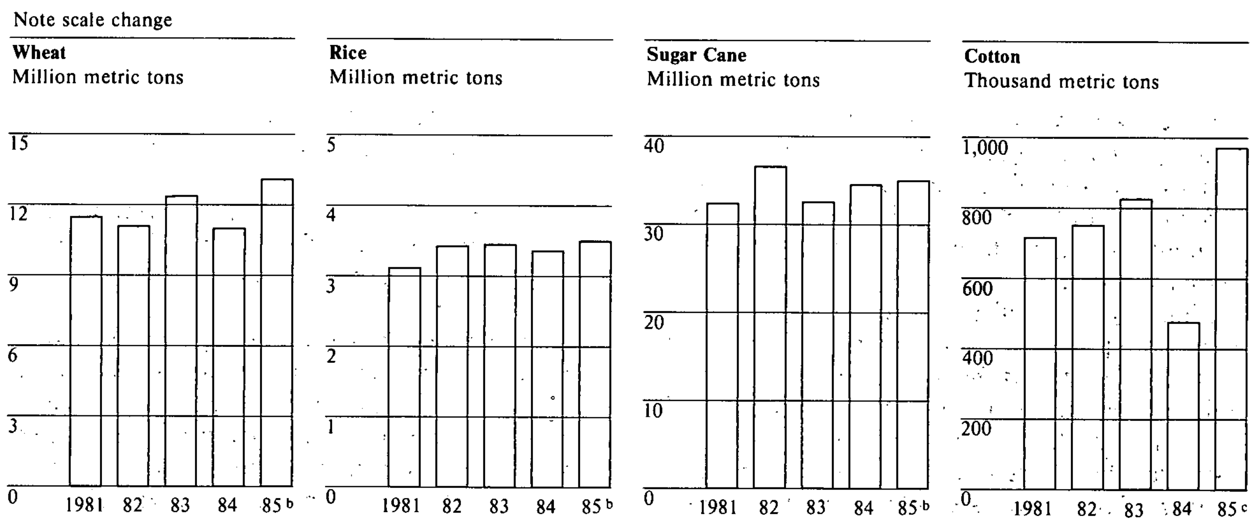
Pakistan: Agricultural Production, 1981-85[a]



[a] Data are for fiscal years ending 30 June of the stated year.
[b] Forecast.
[c] Estimated.

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year's proposed higher wheat procurement prices will be passed on to the consumer. 25X1

Cost of Buying Stability

Because the government steadfastly refuses to either reform the tax structure to bring in new revenue or expand the money supply, the budget deficit continues to grow. The deficit in FY 1984 was 24 percent higher than in FY 1983, and we expect it to rise again this year. The US Embassy reports that fixed expenditures such as defense and debt servicing are taking half the current budget. Pressure on the budget is causing spending cutbacks in education and in routine maintenance of the country's infrastructure.

Current expenditures, such as food subsidies, military spending, and debt service, have cut into development programs. Development spending, which has been declining as a share of the total budget since Zia took power, fell in real terms last year. With the slowdown in capital investment, Pakistan is losing ground in its effort to provide jobs for its rapidly growing population. The lack of domestic funds for development also hinders the utilization of foreign aid, most of which is tied to projects that also require some government funding. There currently is a large backlog in the aid pipeline. 25X1

The government likely will find the deficit even more difficult to finance over the next year. Declining worker remittances and the move to interest-free "Islamic" banking probably will reduce funds available to the government. Recently about half the deficit, for example, has been financed through small savings deposits in government-sponsored schemes that paid attractive rates of interest. 25X1

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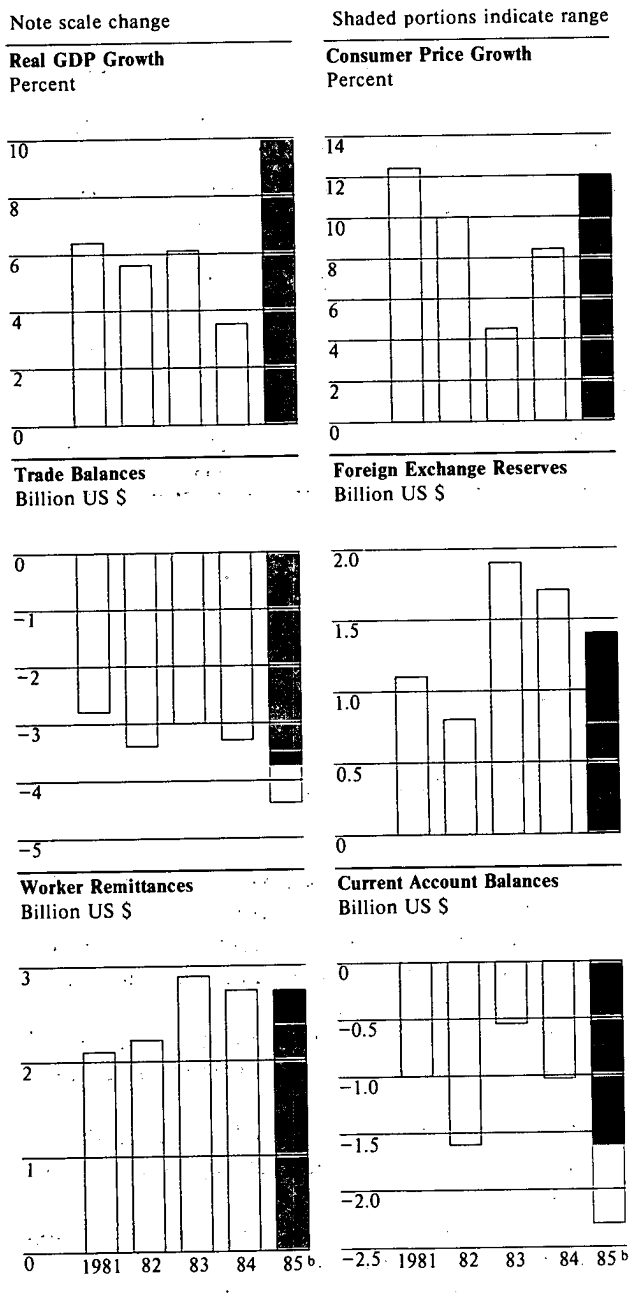
Pakistan: Economic Indicators, 1981-85[a]



[a] Data are for fiscal year ending 30 June.
[b] Projection based on six-month reporting and government plans.

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Bad News for Balance of Payments

Pakistan's foreign payments position is deteriorating rapidly because of a projected record trade deficit, declining remittances, and a growing debt service burden. In first half FY 1985, Islamabad drew down foreign reserves by an estimated $700 million. 25X1

Pakistan's foreign debt repayment burden is likely to exceed $1 billion this year. Most of this is owed to the consortium of Western countries and multilateral institutions that have lent money to Pakistan at concessional rates; the United States is the major contributor. In addition, payments to the IMF are projected at $225 million, and interest payments on US Foreign Military Sales (FMS) credits will grow to an estimated $66 million. 25X1

Despite a push, export earnings during the first half of FY 1985 dropped by over 6 percent from the first half of FY 1984. About half the drop was attributed to the lingering effects of the disastrous cotton crop in FY 1984. At the same time, import costs rose by 15 percent—mainly because of price increases—pushing up the trade deficit. 25X1

Remittances and Foreign Workers

Remittances received through the banking system for the first half of FY 1985 were 13 percent below the same period in FY 1984. A Planning Ministry official believes the decline has bottomed out for the year, but, even if he is right, we estimate that remittances will still fall about $500 million below the peak in FY 1983. According to the Minister of Planning and Development, Islamabad did not anticipate the decline in remittances or a return of workers. In fact, the five-year plan assumed an average annual growth in remittances of nearly 9 percent and a net outflow of workers. 25X1

Some government planners are now assuming a net annual reduction of 10,000 to 15,000 in the 1.5 to 2.0 million Pakistanis working abroad, but the

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Pakistan: Balance of Payments [a]

Million US $

	1981	1982	1983	1984	1985 [b]	1985 [c]	1986 [d]
Current account	**−991**	**−1,610**	**−554**	**−1,028**	**−1,038**	**−1,650**	**−1,600**
Trade balance	−2,765	−3,450	−2,989	−3,334	−3,482	−3,700	−3,500
Exports (f.o.b.)	2,798	2,319	2,627	2,668	3,126	3,000	3,600
Imports (f.o.b.)	5,563	5,769	5,616	6,002	6,608	6,700	7,100
Net services and transfers	1,774	1,840	2,435	2,306	2,444	2,050	1,900
Worker remittances	2,095	2,224	2,886	2,737	2,740	2,400	2,400
Long-term capital (net)	581	746	1,276	882	999	1,000	1,200
Gross disbursements	956	1,092	1,301	1,234	1,418	1,420	1,600
Amortization payments	516	492	386	542	520	520	550
Other	141	146	361	190	101	100	150
Other and short-term capital	772	629	390	−34	−236	−250	−300
Financial gap	**−362** [e]	**235**	**−1,112** [e]	**180**	**275**	**900**	**700**

[a] Fiscal year ending 30 June of the stated year.
[b] Pakistani projections made last October.
[c] CIA projection.
[d] CIA projection that assumes no new import quotas, debt rescheduling, or significant new foreign assistance.
[e] Surplus for the fiscal year.

[redacted] 25X1

recent rate of return suggests that the planners are still too optimistic. Nearly 70,000 Pakistani workers left Saudi Arabia last year and another 10,000 have left thus far this year, [redacted] Another study shows that returnees from Abu Dhabi exceeded new hires during the first nine months of 1984 by 50 percent. [redacted]

Although most of the returning workers are not likely to find good jobs, they probably will not be a serious political liability. They are small in number compared with the total work force, and most of them have some savings. A massive return of workers is not likely because the Saudis as well as the other Gulf states still need a large foreign work force to maintain a high standard of living, and the Pakistani military plays an important role in many of these countries. [redacted]

Economics in the Campaign

Economic conditions have not been a major campaign issue in part because a large segment of the population is relatively prosperous:

- Zia's consumer-oriented spending policies have lessened the burden of potential price increases for most of the population.
- Farmers have enjoyed rising incomes because of good weather and higher government procurement prices.
- The economic health of many lower-class Pakistanis continues to be sustained by family members in the Middle East.
- Bazaar merchants, traders, and owners of cottage industries and service establishments have benefited from the growing purchasing power of the population. [redacted]

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The Financial Crunch—Sooner or Later

The improving domestic economy will probably give Pakistan only a little breathing room with its foreign payments problems. Increased exports are not likely to completely compensate for declining remittances and a growing debt service burden:

- Cotton is in ample supply worldwide, and global textile competition is holding down prices of cotton textile exports.
- Because the wheat crop will not be harvested until spring, it will be mid-1985 before export gains can be realized.
- Rice export earnings will be constrained because prices in Asia have been falling.
- Some of the import savings from increasing domestic oil production and declining world crude oil prices will be offset by rapidly growing domestic energy demand. 25X1

Thus, Zia must soon turn his attention to the balance-of-payments problems if Pakistan is to avoid a financial crunch. If reserves fall at the pace of the first half of the fiscal year, they could be down to $300 million by the end of the fiscal year—equivalent to less than three weeks of imports. 25X1

We believe that, before the end of the next fiscal year, Pakistan will need additional foreign assistance to shore up its shaky international payments position or will have to institute a domestic austerity program including a cutback in imports. The Planning and Development Minister has already made veiled comments about balance-of-payments problems when giving his good news about economic growth. 25X1

Pakistan recently requested an advance on its 1985 FMS loan to avoid falling behind on FMS interest payments. In a related move, Islamabad indicated a willingness to accept concessional financing for future FMS loans after rejecting earlier US proposals on the grounds of preserving its nonaligned status. The decision came too late to be considered for the funds they expect to receive in 1986. 25X1

Zia probably will first come to the United States for additional financial assistance if the foreign payments situation continues to slide. If Pakistan turns to the IMF and other Western aid donors, they probably will insist Islamabad move faster to reform its tax structure, increase domestic energy prices, and reduce consumer subsidies—issues deferred by Zia in his quest for domestic tranquillity. 25X1

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International Financial Situation: Political Update [redacted]

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The governments of several financially troubled countries recently have come under pressure as opposition groups mounted strikes and protests against austerity measures and perceived economic mismanagement. [redacted]

In **Jamaica**, fuel price increases touched off three days of widespread protests that left seven people dead. The demonstrations—which brought Kingston to a virtual standstill—were the most serious in the four years since Prime Minister Seaga took office. Although few incidents occurred in the main resort areas, tourism has declined sharply. Seaga rode out the protests without making concessions on oil price hikes, but the episode may further weaken support for him. In our judgment, the abrupt price increase and the perception that Seaga failed to anticipate fully the reaction will reinforce growing criticism by the public and the ruling party of his leadership and economic policies. Moreover, the incident has revitalized opposition leader Manley, who has called for early national elections. [redacted]

Renewed strike activity in **Bolivia** last month has aggravated the already precarious economic situation, according to the US Embassy. A three-week walkout by factory workers has caused production to plummet. Food shortages have become more pronounced, and a nationwide shutdown by private banks prevented Bolivians from cashing their January salary checks. Meanwhile, La Paz devalued the peso by 80 percent; increased food, fuel, and transportation prices by an average of 400 percent; and authorized a 330-percent wage hike. In our judgment, although labor leaders have not yet called for a general strike, they are encouraging protests in an effort to force President Siles to scale back these austerity measures. A nationwide strike would heighten military concern and provide radicals in the labor movement new opportunities for provoking violence. Economic gains from the measures are likely to prove ephemeral as concessions to labor continue to fuel hyperinflation. [redacted] 25X1

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In the **Dominican Republic**, a one-day nationwide strike virtually halted all commercial activity in Santo Domingo, according to press and US Embassy reports. The leftist-backed demonstration capped several weeks of protest against IMF-supported price increases. Troop deployments to potential trouble spots and arrests of prominent Communists, however, helped prevent violent confrontations. To head off further unrest, President Jorge Blanco cut prices of some basic commodities and took steps to raise minimum wages. [redacted] 25X1

In **Turkey**, dissatisfaction with Prime Minister Ozal's government has risen partly because of lack of progress on economic problems, [redacted] 25X1 Ozal is drawing 25X1 increasing criticism for his recent introduction of a value-added tax, which has proved to be confusing and difficult to enforce. In our judgment, the Prime Minister's failure to reduce the 55-percent inflation rate also has diminished his popularity. Ozal probably will have to show some economic gains within the next six months or so if he is to avoid serious political difficulties with President Evren, the military, and his own party. [redacted] 25X1

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Sporadic disturbances broke out in **Sudan** over bread and gasoline shortages. According to the US Embassy, President Nimeiri closed all schools in Khartoum as a precaution against broader demonstrations. More protests are likely if the shortages persist. [redacted]

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The US Embassy reports that organized labor in **Uruguay** has taken advantage of the power vacuum preceding President-elect Sanguinetti's inauguration and staged widespread strikes. Although the economic disruption has been limited, the agitation demonstrated the health of the labor movement after more than a decade of suppression under military rule. The strikes affected both the public and private sectors and mostly called for wage increases. [redacted] 25X1

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